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C O N F I D E N T I A L SECTION 01 OF 02 MELBOURNE 000058

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TAGS: ECON ETRD EFIN AS
SUBJECT: BANKING CHIEFS CONCERNED ABOUT AUSTRALIA CREDIT
DOWNGRADE

Classified By: Justin Kolbeck, Pol/Econ Officer for Reason 1.4(d)

Summary

¶1. (C/NF) The CEO of Australia's largest bank and J.P. Morgan's Chairman for its Australia and New Zealand business see Australia losing its AAA credit rating as one of the worst case recession scenarios. While both characterized the downgrade as unlikely, they expressed concern that the impact would be profound in a country that funds its current accounts deficit almost exclusively via foreign borrowing. The banking chiefs reaffirmed an oft-heard sentiment: that Australia has yet to see the worst of the slowdown, that job losses will continue to mount, and that a recovery in U.S. confidence will be a critical component to ending the Australian recession. End Summary.

Implications of a Credit Downgrade

¶2. (C/NF) Ralph Norris, Commonwealth Bank's CEO and Rod Eddington, Chairman of J.P. Morgan's Australia and New Zealand business separately expressed concern over the prospect of Australia losing its AAA rating. During an April 22 meeting, Norris told CG that Australia's current account deficit is funded almost exclusively from foreign lending and a credit rating downgrade would "ripple through the real economy." While he said a downgrade is "not particularly likely," Norris did not discount the possibility and went on to say that he has warned Prime Minister Rudd to be cautious in his various stimulus packages to not be seen as "directing the banks" because rating agencies would view this negatively.

¶3. (C/NF) Eddington, in a separate meeting on April 27, was less optimistic, noting that both he and Prime Minister Rudd "lose sleep" over the possibility of a credit downgrade. (Note: Eddington serves as an advisor to Rudd in his capacity as Chairman of Infrastructure Australia and told Consul General that he is a long time Labor Party supporter, and meets regularly with the Prime Minister. Eddington also sits on the board of mining giant Rio Tinto, was once CEO of British Airways and is being considered for the Chairmanship of Australia's second largest bank, ANZ. End note.)

¶4. (C/NF) Local analysts have worried that a significant accumulation of foreign debt combined with escalating national budget deficits could strip Australia of its AAA rating and consequently saddle Australian households and businesses with higher interest rates as the economy continues to slow. Eddington added to this, saying that the Rudd government's stimulatory plans to invest heavily in infrastructure would be significantly undermined by a reduction in Australia's credit rating and the resulting increase in interest costs.

Australian Economy

¶5. (C/NF) According to Norris, the global slowdown has forced Commonwealth to scale back acquisitions and other investments, but he noted that he is "reasonably comfortable" with his bank's capacity to weather future financial turmoil. He explained that the bank is wary of acquiring assets or companies that may have unknown or immeasurable quantities of "toxic assets." Norris added however, that Commonwealth remains bullish on the banking market in Indonesia and is positioning itself as a regional Asian bank. (Note: Post has heard a similar sentiment regarding shifting from an Australia/New Zealand focus to a wider Asian approach from ANZ's leadership. End note.) Commonwealth, he continued, will likely take a hit however in its credit card, unsecured debt, and small/medium business lending which together constitute approximately 50 percent of the bank's book.

¶6. (C/NF) Norris and Eddington both agreed that active fiscal and monetary stimulus led by the Rudd government had delayed Australia's entry into the global recession. They both believe that a recovery in U.S. confidence will be necessary, however, for the Australian economy to make a full recovery. Eddington remarked that the Australian stock market "had fully priced in" the bad economic news on March 9-10 (read: hit its bottom), but the Australian economy has yet to see the worst of the downturn. He believes jobs losses will continue to mount for at least the next twelve months.

Response to U.S. Stimulus Activity

¶7. (C/NF) Norris and Eddington both said that they admire the United States for our collective ability to learn from our mistakes and quickly move on. Norris added that two consecutive positive quarters (June, September) would go a long way to restore worldwide confidence. He said, however, that recent attempts at regulation in the United States "have not been well coordinated," and that he does not see substantial new banking regulations in Australia's future. Eddington expressed concern, that key appointments at the U.S. Treasury department are moving too slowly; it is "important for the engine room to be adequately staffed," he said.

Housing Bubble?

¶8. (C) Despite Commonwealth's recent decision to tighten lending requirements and to raise rates on home loans, Norris said that he is not concerned about an Australian housing bubble. Although the New South Wales real estate market peaked in 2003, he noted that there are some hotspots in Melbourne, Queensland and Western Australia that may "soften." Norris pointed out however, that serviceability on mortgages has improved since the 1991-1992 recession with the average percent of Australian's income spent on their mortgages declining from 15 to 9 percent. Norris estimates Commonwealth's default losses on "bad home loans" at around 1.5 percent. Eddington believes that unlike prior real estate slow downs, there is no glut in either residential or commercial real estate. "We will likely see a 15 percent decline, rather than a 50 percent decline," he added.

Comment

¶9. (C/NF) Post is hearing measured tones of optimism from our business contacts. While there are ominous shapes on the horizon, our contacts are now beginning to talk about a "last in, first out" Australian recession. Most will caveat this optimism, however, by noting that it is still too early to begin to predict the length of the Australian recession and

point out that things will still likely get worse (higher unemployment, lower profits, and continued pressure on manufacturing) before they get better.

THURSTON